Private Equity: A New Role for Finance?*

C.P. Chandrasekhar

If the financial media are to be believed, Asia in general, and India and China in particular, are stealing the good times. Whether it is GDP growth, export performance, foreign reserve accumulation or stock market buoyancy, Asia seems to be where it is all happening. A concomitant of this perspective is intense foreign investor interest in Asia. As a result, the region is an important destination for most investors, including in recent years that most elusive set of intermediaries managing assets for financial investors: private equity firms. What are these entities? How do they behave? And what are the implications of their growing presence?

Portfolio diversification by financial investors in developed countries seeking new targets, higher returns and/or a hedge has over the last quarter of a century taken them into new and ostensibly "innovative" and "alternative" asset classes. One such is private equity, which as originally broadly defined involved investment in equity linked to an asset that is not listed and therefore not publicly traded in stock markets. More recently, private equity firms have invested even in listed companies, though the buy-out by the investor occurs through a *negotiated* process, with the buy-out being friendly or hostile depending on whether the negotiation is with the controlling interest or not. In sum, private equity is acquired either through the private placement of new shares or the sale of pre-existing shares by the controlling interest or minority shareholder, and therefore has features that characterise most take-overs. It can be bought directly by an investor or through an intermediary such as a private equity fund that mobilises capital to finance a set of such investments. However, capital mobilised from investors is substantial enhanced by borrowing to finance acquisitions.

Given the broad definition of what constitutes private equity, a range of transactions and/or assets fall under its purview, including venture capital investments, leveraged buyouts and mezzanine debt financing, where the creditor expects to gain from the appreciation in equity value by exploiting conversion features such as rights, warrants or options. Special funds created to finance such investments have a long history. Originally, their role was in the nature of the development banks of today. Examples of such funds in Europe are Charterhouse Development Capital, established in 1934, and 3i, established in 1945. 3i, which started out as the Industrial and Commercial Finance Corporation, was created by the UK clearing banks and the Bank of England to meet the long-term capital requirements of smaller companies with limited access to financial markets. Similar entities were also established in the US, in this case with the declared aim of commercialising many of the new technologies that had been developed during the war years. Examples are the American Research and Development Corporation (ARD) established in 1946 and the Small Business Investment Companies in the 1950s, all of which were aimed at encouraging technology-based entrepreneurial businesses.

ARD [1]sought to finance its investments by raising institutional capital using a publicly traded, closed-end investment company while the SBICs were supported by or were offshoots of the banks.(EPVCA 2007)[2]

A distinguishing feature of these "financial" investors is that they hired experts who brought to bear their industrial expertise to the assessment of companies, permitting investments that were based on informed expectations of probable success rather than on criteria such as the relative security of the investment concerned. In sum, they blurred the distinction between purely financial investors expecting to reap capital gains and non-financial investors betting on reaping adequate annual returns from long-run involvement in an economic activity. Financial investors or their intermediaries were directing their investments to acquiring a stake, often a controlling stake, with the aim of influencing the performance of companies rather than merely parking funds in financial assets incorporating varying degrees of risk and uncertainty.

Despite the entry of different kinds of investors into this area over the years, even as recently as the 1970s, private equity investment was restricted to venture capital inputs into small firms in fast-growing sectors by high net worth families like the Whitneys and the Rockefellers. Though venture capital investments have come a long way since then, as illustrated by their successes in the information technology area, they account today for a small share of less than a fifth of the private equity business.[3] Non-venture investments have become an important and growing part of the private equity business. In fact, it was the raft of leveraged buy-outs of the 1980s that gave private equity its fame, making it largely an activity which involved the take over of relatively large companies financed substantially with debt.

The transformation of the 1980s was related to two developments in the world of increasingly deregulated finance. The first was the desire of banks and pension funds to find new avenues for investment of their burgeoning resources. The assets of autonomous pension funds in the US, for example, rose from $786 billion in 1980, to $1.8 trillion in 1985, $2.7 trillion in 1990, $4.8 trillion in 1995, $7.4 trillion in 2000 and $8 trillion in 2004 (OECD 2001 and 2003). With investable resources of that magnitude accumulating at that rate, it was not surprising that these entities were keen on entering new areas that would ensure adequate returns to meet their commitments. Public pension funds like the California Public Employees' Retirement System, the largest public pension fund in the US, have taken the lead. According to Politi and Guerrera, (2006), quoting estimates by Russell Investment Group, an investor services company, public pension funds have nearly doubled their exposure to private equity over the past decade and on average invest some 8 per cent of their funds in that asset class. On the other hand, corporate

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[2] European Private Equity and Venture Capital Association, "Why and How to Invest in Private Equity", http://www.evca.com/html/investors/inv_why_01.asp, accessed February 26, 2007.

[3] Figures from "The New Kings of Capitalism", *The Economist*, November 25, 2004. Instances of companies backed by private equity venture capital are Digital Equipment (which went public in 1968 valued at US$37 million after Digital's original funding of US$70,000 in 1959), Federal Express and Apple Computer.

pension funds invest less than 7 per cent and their exposure has decreased slightly since 1995. A similar though different situation characterised the banks. In their case, developments such as the oil price increases of the 1970s, which led to large deposits of petrodollar surpluses, resulted in an increase in their lendable resources and had them also looking for new avenues for investment and lending.

The second development of significance, influenced by the first, was the relaxation of rules relating to investments that could be undertaken by institutional investors like banks and pension funds. In 1971, the Competition and Credit Control policy in the UK gave banks greater investment flexibility. Similarly, in the US, a clarification of the "prudent man" rule (incorporated in the Employee Retirement Income Security Act of 1974)[4] issued by the US Labour Department in 1978 relaxed many of the limitations placed on institutional pension funds allowing them to invest in private equity and other alternative assets. Since then there have been a series of structural and legal changes in Europe and the US, involving *inter alia* pension fund and insurance company regulation, which have had the same impact. These have been accompanied by changes in taxation laws that have encouraged leveraged investments and made investments that promise capital gains more attractive. Most recently in the US, the Gramm-Leach Bliley Act, which became law on November 12, 1999, is seen as having opened new opportunities for lenders interested in mezzanine financing or other equity participation to support leveraged buyouts and other leveraged transactions, and for banking organizations interested in venture capital and other equity-based financing. The law expanded the permitted securities and merchant banking activities of those bank holding companies that are well-capitalized and well-managed. Among these new activities is investment in portfolio companies, the creation of their own qualifying private equity funds or investing in other qualifying private equity funds.

Table 1: Sources of European Private Equity 1998-2002	
Total 1998-2002 (€ billion)	161.3
Shares	Percent
Corporate Investors	8
Private Individuals	6
Govt. Agencies	6
Bnaks	24
Pension Funds	22
Insurance Cos.	12
Funds of Funds	9
Academic Institutions	1
Capital Markets	1
Realised Capital Gains	5

[4] The "prudent man rule" refers to the fiduciary responsibility of investment managers. It requires that an investment manager must only invest funds entrusted to him/her as would a person of prudence, i.e. with discretion, care and intelligence. Before 1978, each investment in a portfolio was expected to meet safety standards in and of itself. Under the revised interpretation, the Department of Labour accepted the concept of portfolio diversification of risk, thereby permitting portfolio managers to invest a small portion of the portfolio in riskier investments as long as the portfolio in the aggregate met fiduciary standards of risk. See Craig (2001).

Others	6
Source: European Private Equity and Venture	
Capital Association at	
http://www.evca.com/html/investors/inv_why_01.asp	

The expansion of funds available for and seeking alternative investments resulted in increased demand for an asset class like private equity, and for agents who could intermediate the investment of such capital. Simultaneously, interest in and concern about private equity increased with the proliferation of private equity firms and funds in which investments were made not just by high net worth individuals but also by institutions such as banks and pension funds. Banks and pension funds account for an overwhelming share of total capital raised by private equity firms. In Europe for example, of the total of Euro 161.3 billion raised between 1998 and 2002, banks, pension funds and insurance companies accounted for 58 percent of the commitment (Table 1). A more general survey of US funds in 2005, conducted by Dow Jones Private Equity Analyst, arrived at a lower but similarly substantial figure: 45 per cent. (Tracy 2006).

The sources of concern are many. Private equity firms or funds are most often limited partnerships, with the firm as the general partner that manages the fund being paid an annual fee (calculated as a percentage of the money invested in and managed by the fund) as well as a share of the profits, if any, garnered by the fund. The investors themselves are limited partners with a right only to a share of the profits.

Since the shares are not traded, the exit from an investment by a private equity investor normally takes one of four forms: (i) direct sale to investors seeking a shareholding in a firm acquired by the fund; (ii) post-purchase listing of the company permitting sale of equity through the stock market; (iii) "recapitalisation" by increasing the debt outstanding and using the money to make dividend payments that the fund distributes to its limited partners; or (iv) sale to another private equity firm, referred to as a secondary buy-out. Realising profits through these means often requires waiting for as long as ten years or more, during which period expectations of an increase in the value of the original investment may or may not be realised. The consequent relative illiquidity of the investment implies that private equity investors expect to take in their returns over the medium or long term, unlike many investors in publicly traded equity. Given the risks involved and the long periods for which capital is locked up, private equity investors normally expect their investments to significantly outperform investments in bond and equity markets. This can create a problem inasmuch as the original investment is based on a purely financial calculation, while the realisation of returns implicit in that calculation requires counterpart investors looking for returns from acquiring an asset that allows engaging in a profitable non-financial activity. That is, the expectations of conventional investors in different kinds of economic activities must match, with a lag, that of pure financial investors represented by private equity firms.

Since private equity returns derive from an appreciation in the value of the acquired asset or company, private equity investments are often followed by efforts at restructuring to resuscitate loss-making companies or substantially improving the performance of profit-making ones. These efforts are aimed at adding value to the investment before private equity investors exit with a profit. Less appreciated forms of intervention by private equity firms are those in which bought-out firms are stripped of assets or are broken up so that the pieces can be sold to the highest bidder for an aggregate sale price that exceeds the purchase price. The revival or improvement of the performance of a poorly performing company must be a prerequisite for ensuring the appreciation of an asset, excepting in cases where: (i) the company concerned was bought cheap and could therefore be sold for a profit, which would be more an aberration than the rule; (ii) the market for the company's products takes a turn for the better, which was not foreseen by the original owner but expected by the private equity firm; or (iii) the company develops a new product or technology which can be commercialised for a large profit, as does happen in the case of some venture capital investments.

While these may be the principles on the basis of which the private equity business is rationalised, in the final analysis the business rests on the fact that "valuations" are speculative. Private equity firms would like to keep their buy-out prices cheap, but loaded with funds find the need to push up valuations to acquire assets. While informed by the profit potential of the target, these valuations do often imply a high degree of risk. But the very fact that such initial valuations are made, by firms led by individuals with a track record, creates an environment for future sale at a price that incorporates a profit. And the longer investors in private equity funds are willing to wait for returns, the longer would fund managers have to wait out the market in search of a profitable sale. Further, in certain circumstances, valuations in the private equity market could influence stock market prices as well, with high valuations in the former encouraging higher price earnings ratios in the latter. This could help the sale of assets through the stock market.

Valuations may also be sticky upwards in the relatively good times, or when there is liquid capital looking for investment avenues, because of a fact noted earlier: the distinction between purely financial capital and capital aiming to derive returns from production of goods or services in the long run has blurred. Increasingly, investments in production are driven by the possibility that the creation of a successful company could offer the option of selling out at a high price, delivering wealth that can be invested in financial assets. Since wealth is measured by the prevailing market value of the asset, the process can feed itself, leading to unsustainable valuations at which someone has to carry a loss. The bourgeoning of finance results in the "dematerialisation" of wealth, permitting wealth accumulation at a pace much faster than the growth of production, so long as the game of rising valuations can be sustained.

What needs to be noted is that this process breeds in an environment of inequality and feeds on it. Global and national inequalities concentrate incomes among a few, whether they be the millionaires in the developed and developing world who accumulate savings looking for avenues of investment or sections of the middle class that accumulate financial capital through investments in mutual and pension funds, that need to be invested to meet future commitments. Neo-liberal reforms reducing State provisions for social security only aggravate this process, since they requires the middle class to save for contingencies or old age. The financial component of neo-liberal reform permits pension funds and insurance companies to invest this capital in a wider range of assets, resulting in the expansion of an asset class like private equity. The financial system adjusts by courting risk.

Since interest in alternative asset classes like private equity is driven by the amount of capital in circulation looking for financial investment opportunities, while the return on private equity is dependent on the demand from investors outside the private equity business for profitable long-term assets, there is a fundamental asymmetry that underlies the business. There could be a period when poor performance in stock markets or low long term yields on bonds, or a combination of the two, results in intensified interest in private equity. To cash in on this interest, private equity firms can trade their reputation to mobilise funds to invest while they search for buy-out opportunities. When the inflow into private equity is large, some or all firms would have to make investments in whose case the probability of subsequent sale at a profit is lower.

This, however, would not deter private equity firms as intermediaries from mobilising large volumes of capital, since a large part of their returns derive from a one time management fee defined as a percentage of the volume of the fund, and are therefore linked to the amount of capital they mobilise. In fact, the evidence seems to be that when funds are aplenty, private equity firms agree to reduce the management fee defined in percentage terms. But with bigger funds, fees only increase. To quote an insider analysis of the problem: "When prospective investors in Bear Stearns Merchant Banking's third buyout fund balked at some details of the fund's planned fee structure, the firm's response at first glance looked quite generous. Bear Stearns dutifully lowered the fund's management fee to 1.75 percent from 2 percent. All other things being constant, the move would have resulted in about $4 million of savings a year for limited partners – a clear win. But other variables changed. Bear Stearns decided to raise the overall size of its fund to at least $2.5 billion from $1.5 billion, meaning it will collect more fees in absolute terms, despite its willingness to give ground on a percentage basis." (Kreuzer 2006)

But this has not deterred investors, at least in the big funds. Figures from Venture Economics suggest that between 1980 and 2000, the amount of commitments of capital to funds managed by private equity firms increased from $2.3 billion to about $177 billion, cumulatively totaling $737 billion (Table 2). However, estimates of the industry's size vary, reflecting the secrecy that shrouds it. According to estimates made by Thomson Financial, 2006 was a record year for private equity in both fundraising and investments. 684 PE funds raised a record $432 billion worldwide in 2006, led by buy-out and real estate funds with $213 billion and $63 billion respectively. The total value of announced private equity buyout deals hit a record $700 billion in 2006, more than double the record set in 2005 and 20 times bigger than in 1996. (Metrics 2.0 2007) According to one study, private equity assets under management are now nearing $400 billion in the United States and just under $200 billion in Europe. Private equity expansion is also reportedly strong with aggregate deal value growing at 51 percent annually from 2001 to 2005 in North America.[5] The largest private equity firms, such as Blackstone, the Texas Pacific Group, or Kohlberg Kravis Roberts & Co.,[6] each control companies with combined net revenues

[5] Figures from Venture Economics; Private Equity; and Buyouts Magazine.quoted in Bloomberg and Schumer 2006.

[6] Prominent private equity firms include: Kohlberg Kravis Roberts & Co., Blackstone Group, Texas Pacific Group, Bain Capital, Carlyle Group, Madison Dearborn, Clayton, Dubilier & Rice, TA Associates, Harvest Partners, and Warburg Pincus. Europe-based firms include: Apax Partners, BC Partners, Bridgepoint Capital, Candover, Cinven, CVC Capital Partners, Permira, Terra Firma Capital Partners and 3i

that exceed most US companies. And the large volumes of committed investor capital controlled by these funds and their substantial access to bank credit make them consider and execute deals that are huge and often unprecedented. One such recent deal is the Blackstone take over, after an intense battle with Vornado Realty Trust, of Equity Office Properties (the publicly traded owner of US office towers) at a price of $39 billion. This is reportedly the largest leveraged buyout ever.

Table 2: New Commitments to Private Equity Partnerships			
Billions of dollars			
Year	Total	Venture	Non-Venture
1980	2.3	2.1	0.2
1981	1.8	1.6	0.3
1982	2.6	2	0.6
1983	5.6	4.2	1.4
1984	6.6	3.2	3.5
1985	6.3	3.1	3.2
1986	8.9	3.7	5.1
1987	21.2	4.8	16.4
1988	15.9	4.5	11.4
1989	17.5	5.6	11.9
1990	10.8	3.1	7.7
1991	7.1	1.8	5.3
1992	18	5	13
1993	22.3	4.5	17.7
1994	30.6	7.6	23
1995	41.8	9.9	31.9
1996	48.2	11.8	36.4
1997	71.7	17.1	54.6
1998	97.4	29.4	68
1999	123.2	60	63.2
2000	177.3	104.8	72.5
1980-2000	737.1	289.8	447.3
Source: Covitz and Liang (2002)			

As a result of their increased presence and activity, private equity firms became a source of controversy in the 1980s, when hostile takeovers through leveraged buy-outs (LBOs) caught the headlines. Their aggression resulted in the movie "Wall Street" and the book "Barbarians at the Gate," which told the story of Kohlberg, Kravis and Roberts' $31 billion hostile takeover of RJR Nabisco. Since then the private equity business has changed in two ways, earning itself a degree of respectability. First, debt constitutes a slightly smaller share of the kitty with which acquisitions are financed, even if debt remains large in absolute terms. This is partly because of the greater availability of funds at least for the most successful private equity firms. According to *The Economist*,[7] when KKR bought America's Safeway supermarket chain in 1986, it borrowed 97 per cent of

[7] "The new kings of capitalism", 25 November 2004.

the $4.8 billion it had to outlay. Today private-equity firms typically contribute around one-third of the acquisition cost from their own equity.

Second, the same report from *The Economist* quoted above, suggests that many of the acquisitions currently being made are not hostile takeovers but friendly arrangements to sell: “big companies that would once have turned up their noses at an approach from a private-equity firm are now pleased to do business with them.”

Respectability also comes from the conviction in certain circles that private equity does fill a gap that was increasingly felt in capitalism. To start with, the disjunction between ownership and control had encouraged perceptions that managers were pursuing their own interests and feathering their own nests at the expense of shareholder interests. The understanding was that the public equity market had come to be characterized by information asymmetries and incentive problems. It was argued that getting private equity firms to take over and manage corporations ensures the maximisation of shareholder value by monitoring and disciplining managers. Private equity firms are also seen by some as characterized by organizational and contractual mechanisms that align the interests of the general and limited partners. Above all, the limited partnership private equity fund is seen as having skills that come from specializing in finding, restructuring and managing closely held private equity assets. These are skills that investors themselves do not posses.

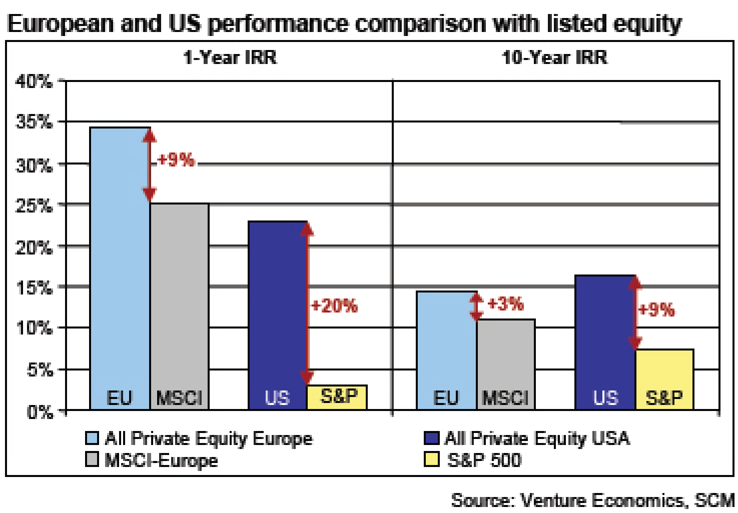
As a result, control through private equity investments is seen as helping shield firms from the messy monitoring that stock market “democracy” and regulation of publicly quoted firms involve. Jon Moulton, who runs the private equity firm Alchemy in London, reportedly told BBC Radio Four's *In Business* programme: "We are the people who run the new conglomerates … I can change a chief executive in five minutes." (O’Keefe 2005).

The defense of private equity notwithstanding, recent developments and deals such as the takeover of Equity Office in the US and the attempted take over of J Sainsbury in the UK have in fact revived the controversy regarding private equity. Such deals proliferate because of a substantial increase of funds managed by the private equity business, especially at a time when bond and equity markets are not seen as performing well enough to satisfy profit-hungry investors.

Clearly, this interest must come from the success in terms of returns from the business. According to the fifth survey of private equity by Strategic Capital Management AG (2006), 2005 was an extremely good year for private equity. A report on the survey’s results states: “The US Private Equity market posted a strong annual performance for the third year in a row and European Private Equity markets showed strong positive performance numbers for the second year in a row. The results achieved by the Private Equity industry were the best on record during the last five years in both the USA and Europe. European buyout partnerships were the best performing Private Equity sector in 2005.” This made the sector’s performance much better than returns in the market for listed equity (Chart 1).

But caution is required in assessing these short term trends. First, taking the industry as a whole, the performance of private equity has not been any better especially in the long run. Steve Kaplan and Antoinette Schoar (2003) investigated the performance of private equity partnerships using a data set of individual fund returns collected by Venture Economics. Over their sample period, average fund returns net of fees approximately equalled the S&P 500. In fact, over 1980 to 2001, the average private-equity buy-out fund generated slightly lower returns to investors (after subtracting fees to general partners) than they would have obtained by investing in the S&P 500. What was of significance was that there were huge differences in performance between individual funds. The top quartile of private-equity funds produced an annual rate of return of 23 percent, well ahead of the S&P; the bottom quartile earned investors only 4 per cent.

Chart 1



David Swensen (2000), chief investment officer of the Yale University, argues based on an analysis of 542 buy-out deals concluded during 1987 to 1998 that the performance of much private equity over the preceding two decades was poor, when seen in light of the facts that (i) interest rates had fallen, thereby reducing the cost of debt; (ii) there were a relatively small number of private-equity firms competing for investments; (iii) there were many badly run and underperforming companies to improve; and (iv) price earnings ratios in public stock markets had registered a sharp rise.

He found that annual returns of 48 percent compared well with the 17 percent return which could have been garnered from investment in the equity of firms included in the S&P index. But he also found that most of these gains came from heavy borrowing by buy-out firms seeking to multiply their investments. If the same amount of debt had been used to multiply the investments in the S&P, he argues, the leveraged portfolio of public equities would have generated an 86 percent return, outperforming the buy-outs by nearly 40 percentage points a year. Not surprisingly, private equity firms speak less of the absolute returns they would offer investors, and only promise to deliver better returns than those available in public equities which they may deliver given the recent poor performance of stock markets.

These assessments have backed expectations that the proliferation in private equity could affect returns from the sector adversely in the near future. Many reasons are quoted for this. To start with, private-equity firms profit more from “proprietary” deals in which they are the only bidders. The costs of acquisition are then lower than they would be if there are competing bidders. However, firms are now increasingly resorting to auctions in sales to private-equity firms. Even in the 1980s, KKR set the record for the biggest buy-out in the course of a bidding war for RJR, only to reap poor returns from the deal. The same can befall deals such as the one Blackstone struck for Equity Office in competition with Vornado.

Second, stock markets are not as buoyant as they were in the 1990s. So the possibility of exploiting high price earnings ratios to list equity and sell at high prices equity acquired cheap in a private deal is far less today. Third, corporations are becoming more circumspect when making costly acquisitions, because of shareholder pressure. Finding corporate buyers for expensively acquired firms, may prove more difficult.

Finally, wielding the hatchet against workers or to break up companies when firms are being restructured is coming up against opposition. Brendan Barber, the general secretary of the Trade Union Congress in the UK recently launched an attack on the private equity industry. (Adams and Smith 2007) Barber said that, while private equity had sometimes turned round ailing companies, operators sometimes gave the impression "of being little more than amoral asset-strippers after a quick buck; casino capitalists enjoying huge personal windfalls from deals at the same time as they gamble with other people's futures." In his view: "The problem is simple: private equity can steer clear of the responsibilities a public company has to live up to. Its owners will disclose as little as possible about what they are doing, and why. In companies that are often leveraged to the hilt, it's employees who end up shouldering much of the risk, with downward pressure on pay, pensions and job security."

Barber has declared his intention to take the attack along two lines. The TUC will shortly produce a briefing paper on private equity for more than 1,000 pension fund trustees controlling £300bn of assets, urging them to "look long and hard" before supporting investments in private equity. And he has promised to urge ministers to regulate an industry "that at the moment is pretty much allowed to operate with impunity".

Meanwhile, criticism is growing among investors as well about the practices and performance of private equity firms. The view that private equity firms align the interests of investors, or limited partners, and the general partners who manage the funds, is under challenge. This is because, as noted earlier, even as funds have grown in size, the management fee defined as a per cent of the fund has reduced little. In the past, general partners were paid an annual management fee of 1.5 to 2 per cent, with a profit share of 20 per cent. These percentages should have fallen to reflect the growing scale of funds under management. In practice, there has merely been a marginal reduction in management fees from 2 per cent to 1.5 per cent. This means that fund managers earn huge fees on the billions of dollars they have managed to raise in recent times, even if the investments do not garner promised returns. The study by David Swensen referred to above found that net of fees, limited partners received lower than market returns with substantial levels of risk while the general partners received large fees. There is evidence that incentive structures are such that general partners satisfied with high fees are not delivering performance and returns to limited partners, in a market that is flush with funds.

A second criticism of private equity is their lack of transparency. Paul Myners, former chairman of Marks and Spencer, whose review of institutional investment in 2002 had recommended that pension schemes should consider investing in a wide range of asset classes including private equity and hedge funds, declared: "We are seeing public companies go private and they go from being transparent and accountable into a dark box." (Packard and Smith, 207). The performance of funds and their underlying businesses should remain as open as those of public companies, he reportedly said.

The secretiveness of private equity has become an issue also because of evidence that oil-rich Gulf countries flush with surpluses are putting their money into private equity investments. Recently, reports linking Qatar's government investment funds to a possible buy-out of J. Sainsbury, as well as a strategic stake in EADS, triggered a controversy.

Third, big private equity firms are now increasingly operating in concert. When they jointly invest in a takeover target, efforts of investors to hedge by spreading their investments across a number of private equity firms are partly defeated. Hedging of this kind is warranted by the sharp differentials in the performance of private equity firms. Further, "secondary buy-outs" where one private equity firm buys out an investment from another private equity investor creates suspicion that this may be a way of helping each other encash investments to pay off limited partners. Collusion of these kinds could result in a further misalignment of the interests of limited and general partners.

Finally, private equity firms are seen as being favoured by government in the UK because of its practice of taxing profits after interest has been deducted. Since private equity firms finance their investments with a high proportion of debt, which reduces taxable profit, buy-out firms are seen as being given an unfair advantage in pursuing their questionable practices.

One result of all this is that private equity firms are finding their business getting harder to conduct in the US and Europe. Not surprisingly, there are signs that the business is increasingly moving overseas, especially to emerging market countries where markets are booming because of foreign institutional investment inflows.

According to Emerging Markets Private Equity Association, fundraising for emerging market private equity surged in 2005 and 2006. Estimated at $3.4 billion and $5.8 billion in 2003 and 2004, the figure shot up to 22.1 billion in 2004 and $21.9 billion in the period to November 1 during 2006. Asia (excluding Japan, Australia and New Zealand) dominated the surge, with the figure rising from $2.2 and $2.8 billion in 2003 and 2004 to $15.4 billion during 2005 and $14.5 billion during the first ten months of 2006.[8]

Deal making in the region has also gained momentum. Dealogic estimates that the value of private equity deals in the Asia Pacific, excluding Japan, more than tripled to $26 billion in 2006 from $7 billion in 2005.[9] Private equity buyouts have accounted for 7 percent of regional merger and acquisition volume this year, up from 3 percent in 2005

[8] "Emerging Markets Private Equity: The current landscape and the road ahead", EM PE Quarterly Review, Volume II, Issue 4 Q4 2006, available at www.empea.net/docs/newsletters/EMPE_QuarterlyReview_Vol2_Issue4.pdf, accessed 2 February 2007.

[9] Metrics 2.0, "Asia Pacific Private Equity Deals Tripled in 2006", http://www.metrics2.com/blog/2006/12/13/asia_pacific_private_equity_deals_tripled_in_2006.html, accessed 27 February 2007

but still below the global figure of 17 percent. Though Australia accounted for $11.7 billion in activity, deals in the Indian subcontinent jumped to $3.1 billion in 2006 from $764 million in 2005, with Kohlberg Kravis Roberts & Co.'s $900 million purchase of Flextronics Software Systems, India's largest deal. North Asia deals totalled $10.4 billion, led by Goldman Sachs' $2.6 billion investment in Industrial & Commercial Bank of China, this year's biggest regional deal. Investment banks have raked in $304 million in net revenue from private equity investors thus far in 2006, compared with $239 million last year.

Table 3: Emerging Markets Private Equity Fundraising ($ millions)

	Asia (ex Jap/ANZ)	CEE/Russia	Latin America	Africa/Middle East	Total EM
2003	2200	406	417	350	3373
2004	2800	1777	714	545	5836
2005	15446	2711	1272	2706	22135
2006	14528	2759	813	3807	21907

Source: "Emerging Markets Private Equity: The current landscape and the road ahead", EM PE Quarterly Review, Volume II, Issue 4 Q4 2006, available at www.empea.net/docs/newsletters/EMPE_QuarterlyReview_Vol2_Issue4.pdf, accessed 27 February 2007.

It must be noted that these figures differ substantially from those provided by Thomson Financial. Thomson's figures point to investment of $7.6 billion in private equity deals in 2006 and does not point to a surge in 2006 (Table 4). However, Thomson does suggest that foreign investments accounted for 63 percent of the Asian private equity market in 2006, with $4.39 billion out of the total.[10]

India's experience is illustrative of the rush of private equity to the developing world. Observers began to take note of private equity's growing presence in India when in late 2002 Oak Hill Capital and Financial Technology Ventures resorted to a buyout deal by backing a management bid to acquire Conseco's stake in Delhi-based EXL Services. Subsequently in September 2003, ICICI Venture bought out the Tatas' controlling stake in Tata Infomedia. Three months later, CDC Capital Partners, the UK-based private equity investor, struck a Rs 75-crore deal to buy ICI India's industrial chemicals business in Gujarat (Sengupta 2004). The private equity asset class had arrived in the country.

Since then, there has been an increase in such activity with all the majors finding their way to the country. Growth has also been substantial. The total number of M&A deals struck in 2006 was estimated at 782 ($28.2 billion) compared with 467 ($18.3 million) in

[10] Thomson Financial (2006), *Thomson Financial Asia Pacfic Private Equity Markets, 2006 Year-end report: Asian Private Equity Reach Record High*, Hong Kong: The Thomson Corporation Hong Kong Ltd.

2005[11]. Of these, 302 involved private equity. Private equity investments also saw substantial growth in 2006. From $1.1 billion invested in 60 deals in 2004, private equity investments rose to $2 billion in 124 deals in 2005, and a remarkable $7.9 billion in 302 deals in 2006. This remarkable 287 percent increase in the total value of private equity during 2006, points to a growing value in each deal. There were more than 29 deals valued at over $50 million as against 10 such in 2005. The average private equity investment size increased from $16.40 million in 2005 to $26.02 million in 2006.

Some of the big deals included Kohlberg Kravis Roberts & Co's $900-million investment in Flextronics Software Systems; Providence Equity Partner's $400-million investment in Idea Cellular and Temasek Holdings Pte's $330-million investment in Tata Teleservices Ltd. Such deals are continuing in 2007 with Blackstone Group acquiring a 26 percent stake in Ushodaya Enterprises Limited , which publishes the Telugu-language newspaper *Eenadu* and owns television channels under the same name.

This ability to acquire equity through the private market suggests that foreign acquisitions could increase sharply in Asia, since it is known that there is a substantial proportion of companies in these countries that are either unlisted or in which free-floating (as opposed promoter-held) shares are a small proportion. Despite this, there has already been some evidence of increased acquisition through the stock market. In India, for example, as per the original September 1992 policy permitting foreign institutional investment, registered FIIs could individually invest in a maximum of 5 per cent of a company's issued capital and all FIIs together up to a maximum of 24 per cent. The 5 per cent individual-FII limit was raised to 10 per cent in June 1998. However, as of March 2001, FIIs as a group were allowed to invest in excess of 24 per cent and up to 40 per cent of the paid up capital of a company with the approval of the general body of the shareholders granted through a special resolution. This aggregate FII limit was raised to the sectoral cap for foreign investment as of September 2001. (Ministry of Finance, Government of India, 2005). These changes obviously substantially expanded the role that FIIs could play even in a market that was still relatively shallow in terms of the number of shares that were available for active trading.

This is because the process of liberalisation keeps alive expectations that the caps on foreign direct investment in different sectors would be relaxed over time, providing the basis for foreign control. Thus, acquisition of shares through the FII route today paves the way for the sale of those shares to foreign players interested in acquiring companies as and when the demand arises and/or FDI norms are relaxed. This creates the ground for speculative forays into the Indian market, with investment banks and hedge funds using various routes, including sub-accounts and participatory notes, to establish a presence. If the expectations underlying such speculative investments are to be realised, sale to a firm seeking to acquire assets to establish an Indian presence would be the best option.

This trend of transfer of ownership from Indian to foreign owners would now be aggravated by the private equity boom, which is not even restrained by the extent of free-floating shares available for trading in stock markets. Private equity firms can seek out appropriate investment targets and persuade domestic firms to part with a significant share of equity using valuations that would be substantial by domestic wealth standards

[11] "2006: Milestone year for mergers, acquisitions", *The Hindu Business Line*, Sunday, 7 January 2007.

even when they may not be so by international standards. Since private equity expects to make its returns in the medium term, it can then wait till policies on foreign ownership are adequately relaxed and an international firm is interested in an acquisition in the area concerned. The rapid expansion of private equity in emerging markets suggests that this is the route the private equity business is seeking given the fact that the potential for such activity in the developed countries is reaching saturation levels. The dematerialisation of wealth has as its counterpart rising foreign ownership in developing countries like India.

If this tendency persists, valuations in emerging markets are bound to rise as well with implications for price earnings ratios in their stock markets too. The fragility that creates in shallow markets with substantial foreign capital presence need not be spelt out. If the boom goes bust, investors from developed countries such as the pension funds and insurance companies could burn their fingers. But this may not deter private equity from traversing this path given the misalignment of incentives driving general and limited partners that was noted earlier. In the developing countries themselves, the bust would have implications that go beyond individual firms and companies, as the recent financial crises in developing countries illustrate.

The other fall-out of this tendency would be a change in the pattern of asset-ownership in developing countries, with foreign investors controlling a rising share of total assets. Many argue that this is inevitable in a globalising world and that ownership *per se* does not matter so long as the assets are maintained and operated in the developing countries themselves. But there is no guarantee that this would be the case once domestic assets become parts of the international operations of transnational firms with transnational strategies. Those assets may at some point be kept dormant and even be retrenched. What is more, the ability of domestic forces and the domestic State to influence the pattern and pace of growth of domestic economic activity would have been substantially eroded.

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